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*By Electronic Delivery*

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U.S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

William J. Wilkins  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

RE: Proposed Section 1256 and NPC  
Regulations

Dear Ms. McMahon and Mr. Wilkins:

The Investment Company Institute<sup>1</sup> (“ICI”) strongly supports Treasury Department and IRS efforts to publish financial products taxation guidance that is clear and administrable. The proposed regulations are welcome as they address the definition of a notional principal contract (“NPC”) and the interaction between the NPC rules and the rules for section 1256 contracts. Our comments on these proposed regulations are somewhat preliminary, however, because the very important questions of timing and character have been reserved for future guidance.

The first part of our letter addresses two important issues raised by the proposed regulations. First, additional guidance is necessary regarding the definition of “payment” in the context of bullet swaps and interim fixed amounts. We ask also that the NPC rules address the proper accounting of amounts that, although fixed during the contract, are not paid until maturity. Second, additional guidance is necessary to clarify whether swap futures contracts are “similar agreements” for purposes of the exclusion from section 1256 treatment.

In the second part, we bring to your attention several concerns related to the NPC rules that are outside the scope of the proposed regulations but are critically important to the fund industry. First, further consideration should be given to the treatment of credit default swaps (“CDS”). Because of the unique economics of CDS, NPC treatment may create several inappropriate consequences. To address these consequences, we urge that CDS be accounted for under the “wait and see” method. Second, due

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.5 trillion and serve over 90 million shareholders.

to the distribution requirements to which they are subject, regulated investment companies (“RICs”) have a special interest in the character of payments under NPCs. Third, we urge that guidance be issued on the tax treatment of exchange traded notes (“ETNs”); these instruments, despite the assertions of one commentator, appear not to be addressed by these regulations.

## I. Issues Raised by the Proposed Regulations

### A. Application of NPC “Payment” Rule to Bullet Swaps and Equity Forward Contracts

Additional guidance is necessary regarding the definition of “payment” and interim fixed amounts in the context of bullet swaps and equity forward contracts. The scope of this definition is unclear in several important respects.

#### 1. The Definition of Payment

The proposed rules provide that an NPC requires one party to make two or more payments to the counterparty. For this purpose, the fixing of an amount is treated as a payment, even if the actual payment reflecting that amount is made at a later date. As a result, a bullet swap or an equity forward contract can be an NPC under the proposed rules even if it provides for only one payment, so long as that payment is calculated, in part, based on an amount that becomes fixed during the term of the contract.

The new definition of “payment” seems to have been crafted with section 871(m) in mind. Under section 871(m), dividend equivalent payments on specified NPCs are subject to withholding tax. The new definition of “payment” would extend the application of section 871(m) to contracts that provide for a settlement payment referenced to the appreciation or depreciation on a specified number of shares of stock, adjusted for actual dividends paid during the term of the contract, such as bullet swaps. While we support extending the scope of section 871(m) where it is appropriate, we are concerned that the new definition will disrupt the established timing and character treatment of bullet swaps and other equity forward contracts.

#### 2. Clarification is Necessary

The new definition of “payment” needs to be clarified in several important respects. First, if the XYZ stock in example two of proposed regulations §1.446-3(c)(6) was a non-dividend paying stock, it is unclear whether the fixing of the dividend-related payment at zero would be considered a payment. If the initial answer is no, it is unclear if a contract would become an NPC if a change to the dividend were made. We believe that the appropriate time to determine whether a contract is an NPC is at inception. Reassessment should not be required for any action, such as a change in dividend policy, which is beyond the taxpayer’s control.

Second, it is unclear what it means for a party to be “required” to make two or more payments. Equity forward contracts often contain adjustment provisions to account for extraordinary dividends, but not for ordinary dividends. In this circumstance, it is not clear whether the conditional possibility of a payment should be viewed as a required payment.

Funds are troubled by the potentially broad application of this rule. Aside from our concern that the status of a contract could change from the time it is entered into, an expansive view of what constitutes an interim fixed amount could call into question the established treatment of commonly transacted instruments. The examples in the proposed regulations make clear that an interim fixed amount includes dividends and variable rate interest. There is little economic justification, however, for treating the declaration of a dividend as a payment because, in most cases, the dividend declaration will result in a corresponding reduction in the value of the stock on which the dividend is paid. Bullet swaps and equity forward contracts typically have been taxed as open transactions. The definition of “payment” under the proposed rules risks upending this treatment with little or no economic justification for doing so.

Furthermore, application of the concept could be extended to cover notional gains and losses from an equity forward contract tied to the periodic rebalancing of an index. Many equity forward contracts are linked to indices, such as the S&P 500 Index, that periodically “rebalance.” At the time of a rebalancing, investors may be credited for locked-in gains and losses under the terms of the contract. How should taxpayers distinguish between changes in the component stocks of an index in the context of the S&P 500 Index futures contract and the fixing of an amount in the context of other equity forward contracts? This uncertainty would extend also to contracts that are tied to an excess return index or other index that replicates a trading strategy (*i.e.*, an index based on the Dogs of the Dow).

Compliance with the rule will require extensive due diligence into the provisions of each contract to assess whether a specific calculation includes an interim fixed amount. Mutual funds require tax certainty in order to meet their annual distribution requirements. We request clarification, in particular, on the uncertain application of the new “payment” rule in the context of dividend declarations and index rebalancings.

In addition, we agree that the proposed regulations should be effective on a prospective basis. To the extent a taxpayer must seek IRS consent for an accounting method change regarding the characterization of a swap transaction, we urge that consent be automatic.

#### B. The “Similar Agreements” Exclusion from Section 1256 and Swap Futures Contracts

Additional guidance is necessary regarding the types of contracts that are “similar agreements” for purposes of the exclusion from section 1256 treatment. In particular, the status of swap futures contracts is uncertain.

Many taxpayers currently treat swap futures contracts as “section 1256 contracts.” Swap futures contracts come in several variations. Certain swap futures contracts, like the Chicago Mercantile Exchange (“CME”) Swap Futures Contract, presumably are not NPCs under the new definition because they do not provide for multiple payments (even under an expansive view of interim fixed amounts).

The status of swap futures contracts as “section 1256 contracts,” however, is uncertain under the proposed rules. The preamble to the proposed regulations asserts that Congress was attempting to harmonize the category of swaps excluded under section 1256(b)(2)(B) with swaps that qualify as notional principal contracts under Treas. Reg. §1.446-3(c). Based on that assertion, certain swap futures contracts presumably still may be considered “section 1256 contracts” because they are not NPCs. This treatment, however, is unclear.

Future on swaps, like options on swaps, are closely connected to the underlying contract. The proposed rules deem options on NPCs (which are not themselves NPCs) to be “similar agreements” for purposes of section 1256(b)(2)(B). The proposed regulations, however, are silent on the status of futures on NPCs. If the Commodity Exchange Act requires futures on swaps to be reported as swaps, then they would not be considered “section 1256 contracts” under the proposed rules. Regulations under the Commodity Exchange Act, however, have not been issued yet.

We request confirmation in the final regulations that swap futures contracts that are not NPCs will continue to be treated as “section 1256 contracts.” In addition, we request confirmation that any reasonable interpretation of “similar agreement” under section 1256(b)(2)(B) will not be challenged for contracts entered into before the regulations are finalized.

## II. Proper Timing and Character Treatment

### A. Timing Concerns – Credit Default Swaps

Further consideration should be given to the treatment of credit default swaps. Because of the unique economics of these transactions, NPC treatment may create several inappropriate consequences. To address these consequences, we urge that settlement payments under CDS be accounted for under the “wait and see” method.

We believe Treasury and the IRS should craft guidance that is specifically suited to the unique economics of CDS. Under section 1256(b)(2)(B), CDS clearly are not “section 1256 contracts.” CDS have substantially different economics than other types of swaps and should not be treated like swaps that clearly are NPCs. Indeed, certain single payment CDS would not be considered NPCs even under the proposed rules.

CDS, more typically, call for multiple payments in which one party (the “credit protection buyer”) makes periodic payments to the counterparty (the “credit protection seller”) in exchange for the counterparty’s agreement to make a payment, or purchase a security, in the event of a specified credit event, such as default by the issuer of a reference security.<sup>2</sup> Each periodic payment fairly can be seen as purchasing credit protection for that period. For example, if a periodic payment is made each calendar quarter, it protects the credit protection buyer against risk of default during the quarter. The credit protection seller may make a payment at any point during the term of the contract. Thus, unlike an equity swap, for example, periodic payments on a CDS do not represent a cumulative investment in a single back-end payment. Indeed, the credit protection seller likely will not make any payment at all to the buyer.

We understand that the Government still is considering the appropriate timing rules for CDS. The uncertainty of if and when a payment will be made by the credit protection seller makes the noncontingent swap method inappropriate for CDS. In comments on Notice 2001-44, we responded that the modified noncontingent swap method is too complex and should be reserved for swaps with contingent payments where the timing is certain.<sup>3</sup>

The “wait and see” method is the most appropriate method of accounting for settlement payments under CDS, whether they require a single payment or multiple payments. Under this approach, parties that have entered into a CDS would include and deduct payments in the period to which they relate. If a credit protection payment is made, the payment should be included and deducted when the default triggering the payment occurs. Please refer to our comments in response to the proposed contingent nonperiodic payment NPC regulations for a full discussion of our proposal.<sup>4</sup>

We understand that Treasury and IRS intend to propose timing rules in the near future. These timing rules must be issued before the proposed NPC rules are finalized. Without an understanding of the timing rules, taxpayers simply do not have adequate information to assess fully the proposed regulations. Accordingly, when timing rules are proposed, taxpayers should be granted additional time to comment on the proposed NPC rules as well.

## B. Character Concerns

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<sup>2</sup> CDS may have multiple reference securities. A CDS with two or more, usually between three and ten, reference securities is known as a basket CDS. In the case of an index CDS, the CDS will offer protection on all securities that comprise an index.

<sup>3</sup> See ICI comments on Notice 2001-44, dated May 22, 2002.

<sup>4</sup> ICI letter to Gregory F. Jenner and Donald Korb, dated July 21, 2004.

Regulated investment companies need certainty regarding the character of their income due to the Internal Revenue Code's distribution requirements and the Investment Company Act of 1940's restrictions on the number of capital gain distributions that RICs can make.

RICs may enter into swap transactions for a variety of reasons, depending on the nature of the swap and the investment strategy adopted by the RIC. A RIC investing in stocks of large companies, for example, may purchase a swap to gain broad exposure to the equity or bond markets. RICs also may hold swaps, including CDS, as a hedge against risks of other portfolio investments.

If the value payment on swaps, such as bullet swaps and CDS, is treated as a capital gain or loss, as we believe is appropriate, then the distributions to shareholders associated with a swap investment will have the same character as gain from a direct investment in equity or bond markets and gain from other derivatives such as options or forward contracts on equities. If the gain or loss from a value payment is treated as ordinary, however, any income will be distributed differently and perhaps to different shareholders. Treating market value change returns as ordinary income may raise significantly the volatility of a fund's distributions. This volatility is particularly unsettling to those bond fund investors who rely on a relatively stable flow of income from their investment. Moreover, an ordinary loss from swap value payments could result in a RIC distribution being treated as a return of capital to shareholders. For these reasons, RICs have a special interest in the characterization of payments under NPCs.

### C. Exchange Traded Notes

We urge Treasury and IRS to issue guidance on the tax treatment of exchange traded notes. These instruments, despite the assertions of one commentator, appear not to be addressed by the regulations.<sup>5</sup>

We encourage Treasury and IRS to address ETNs under a separate guidance project that provides a comprehensive solution to the challenges ETNs present to the tax system. ETNs utilize gaps in the tax law to provide investors with tax deferral (for certain ETNs with long maturities, deferral can be up to 30 years) and character conversion that is inappropriate. This treatment is far more favorable than the treatment obtained by investors in comparable financial instruments and is attributable to the fact that ETNs do not fit neatly into any established financial products "cubbyhole."

A comprehensive solution should be based on constructive ownership principles and time value of money concepts. The ICI made a detailed submission with this suggestion in a letter to Treasury and the IRS in May 2008.<sup>6</sup>

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<sup>5</sup> See Amy S. Elliot and Lee A. Sheppard, "Proposed Derivatives Regulations Shouldn't Change Position on Bullet Swaps," 2011 Tax Notes Today 210-2 (10/31/11) (reporting on comments made by practitioners and IRS officials at the Practising Law Institute conference on corporate tax strategies on October 28, 2011).

A constructive ownership approach affords a comprehensive approach to ETNs because it would tax ETN investors in accordance with the economics of their investments. In many cases, an ETN investor is seeking the return from a dynamic trading strategy (*e.g.*, the economic return of owning, over time, the ten stocks that, each year, are in the Dogs of the Dow). Constructive ownership taxation properly measures this return. Please refer to our letter for a full discussion of our proposal.

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We look forward to discussing these issues with Treasury Department and Internal Revenue Service officials. We will be contacting members of your staffs shortly regarding this submission. Please feel free to contact me (at [pinank.desai@ici.org](mailto:pinank.desai@ici.org) or 202/326-5876) or Keith Lawson (at [lawson@ici.org](mailto:lawson@ici.org) or 202/326-5832) if you would like additional information regarding any issue we have raised in this letter.

Sincerely,

/s/ Pinank Desai

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Assistant Counsel – Tax Law

cc: Steve Larson  
Scott Brown  
Jeff Van Hove  
Karl Walli  
Mike Novey

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<sup>6</sup> ICI letter to Eric Solomon and Donald Korb, dated May 13, 2008.